IN THE

United States Court of Appeals

For the Ninth Circuit

NO. 22387

WESTERN TERMINAL COMPANY, APPELLANT

vs.

UNITED STATES OF AMERICA, APPELLEE

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF WASHINGTON

BRIEF FOR THE TAXPAYER-APPELLANT

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BRIEF FOR THE TAXPAYER-APPELLANT

OPINION BELOW

The Findings of Fact and Conclusions of Law of the Court below has not been officially reported. The Findings of Fact and Conclusions of Law are recited in the Record of the District Court (2R.24-28).

JURISDICTION

This appeal involves federal income taxes for the year 1960. On June 3, 1964, the taxpayer paid a deficiency in its income taxes for 1960 of $203,222.05 (1R.2,11). A timely claim for refund was thereafter filed which was rejected

on April 2, 1965 (1R.2,11) within the time provided in Section 6532 of the Internal Revenue Code of 1954, and on March 18, 1966, taxpayer brought this timely action in the District Court for recovery of the taxes paid (1R.1,11). Jurisdiction was conferred on the District Court by 28 U.S.C. Section 1346(a). The judgment of the District Court in favor of the Government was entered on September 1, 1967 (1R. 9). Within thirty days thereafter, on September 26, 1967, the taxpayer filed a Notice of Appeal (1R.30). Jurisdiction is conferred on this Court by 28 U.S.C. Section 1391.

QUESTIONS PRESENTED

1. Did the District Court err in holding that the taxpayer's fuel storage facility located near Grand Forks, North Dakota, had a 20 year useful life at the end of 1960?

2. Did the District Court err in holding that it was proper to consider hindsight evidence in determining the useful life of taxpayer's fuel storage facility?

STATEMENT OF THE CASE

Most of the basic facts are not in dispute. These facts appear in the Pretrial Conference Order (1R.10-15) in paragraphs 1 through 13, 15 through 17 and 20 of the District Court's Findings of Fact and Conclusions of Law (1R.24-27), and in the several exhibits introduced into evidence at the trial by the Taxpayer-Appellant and the Appellee.

The facts fall into two basic groups, those which were

known at December 31, 1960 and those which were not known at December 31, 1960 but arose thereafter.

1. Facts known at December 31, 1960

The following facts were known at December 31, 1960:

(a) Plaintiff was organized on February 11, 1959 for the purpose of bidding and, if successful, constructing and operating a fuel storage facility to be located adjacent to the Grand Forks Air Force Base at Grand Forks, North Dakota. (1R.24)

(b) By transmittal letter dated February 21, 1959, Plaintiff submitted to the Government its request for proposal in respect of a 670,000 barrel capacity fuel storage facility to be located near Grand Fords, North Dakota. Included among the schedules to such request for proposal was a cost estimate in which the cost of the facility was amortized over a five year useful life (Plaintiff's Exhibit 3) (2R.70).

(c) On April 22, 1959, Plaintiff was awarded a contract for storing and handling Government-owned petroleum products at Grand Forks, North Dakota (Plaintiff's Exhibit 5). This contract called for the construction of a fuel storage facility with a 670,000 barrel capacity (2R.66-72).

(d) Following the start of construction of the above mentioned facility, the Plaintiff received a telegram from the Defense Fuel Supply Center requesting it to stop construction of the 670,000 barrel capacity facility and further re-

questing it to come to Washington, D. C. to enter into discussions regarding changes in the contract terms and conditions to cover a reduction in the total amount of fuel storage tankage to be provided. (Plaintiff's Exhibit 6) (2R.74-75).

(e) As a result of the negotiations which followed, a new contract, dated May 8, 1959, was entered into for the construction and operation of a fuel storage facility at the same location but having a capacity of 270,000 barrels; (2R.75) (Plaintiff's Exhibit 1). The contract was for a period of five years. Pursuant to the terms of the contract, the Government was granted the option and successive options to renew for three additional periods of five years each or a total of 15 years. (1R.25) (Section VIII, Plaintiff's Exhibit 1).

(f) Under the terms of the contract, Plaintiff was to be paid a monthly use charge computed at the rate of $2.36 per barrel per year of storage capacity. This use charge was to be reduced to 59¢ per barrel per year of storage capacity during the first option renewal period and 44¢ per barrel per year of capacity during the two succeeding option renewal periods. (Section I, Plaintiff's Exhibit 1). The reason for the substantially larger use charge during the first five year period was to permit Plaintiff to recover its investment in the fuel storage facility, its operating expenses, and a profit. (2R.81-82) (1R.25). The smaller use charges during the renewal periods were intended to cover only the normal operating costs and a small profit. (2R.68,82).

(g) Pursuant to paragraph C of Section XII of the contract, the Government reserved the right to terminate the contract for its convenience by paying the Plaintiff the following sums:

(i)	During the first year after the facility had been accepted by the government	$1,875,000.
(ii)	During the second year of the contract period	$1,650,000.
(iii)	During the third year of the contract period	$1,237,500.
(iv)	During the fourth year of the contract period	$ 825,000.
(v)	During the fifth year of the contract period	$ 412,500.
(vi)	During any renewal period of the unexpired portion of the use charges due at the date of termination under any five-year renewal period at the use charge rates for the particular renewal period during which termination occurs.	thirty percent

(h) The contract could be terminated without cost to the Government at the end of the first five year period and at the end of any renewal period (Par. C of Section XII of Plaintiff's Exhibit 1).

(i) Under the terms of the contract, a total of $3,186,000 was to be paid to Plaintiff during the initial five year pe-

riod. This sum was based upon the following estimates of cost, operating expenses and profit:

Construction Cost	$1,875,000
Termination Settlement	162,000
Operating Costs—5 years @ $124,500 per year	622,500
Interest on Construction	326,625
Total Estimated Costs	$2,986,125
Profit	199,875
Firm five year price	$3,186,000

(j) Assuming the contract was not later modified and that the Government exercised all three of its successive five-year options, Plaintiff would receive additional payments of $1,984,500 during the three successive option renewal periods (1R.25).

(k) Funds for the construction of Plaintiff's fuel storage facility were borrowed from the Old National Bank of Spokane, The National Bank of Minneapolis, and the Red River Bank of Grand Forks, North Dakota. (2R.95) Prior to the lending of these funds, Plaintiff delivered to the lending banks a pro-forma financial statement setting forth the projected cash flow under the contract. This pro-forma statement was based upon a five year estimate of useful life for the fuel storage facility. (Plaintiff's Exhibit 4) (2R.190-196, 228-229).

(i) Construction of Plaintiff's fuel storage facility was be-

gun on April 27, 1959 and was completed on September 1, 1959. The fuel storage facility was to be used for the receiving, storing and distribution of petroleum products to the Grand Forks Air Force Base. This base was located some 15 miles from the site of Plaintiff's fuel storage facility. (1R.26)

(m) The cost of Plaintiff's fuel storage facility was as follows:

Land	$ 35,935.10
Terminal Facilities	794,266.66
Pipelines — off site	294,505.60
Total	$1,124,467.36

(n) The cost of the depreciable assets included in Plaintiff's fuel storage facility was $1,088,532.26 (1R.26).

(o) Plaintiff's fuel storage facility constituted property used in its trade or business of a type subject to an allowance for depreciation under the provisions of Section 167 of the Internal Revenue Code of 1954 (1R.26).

(p) Plaintiff at all times during the year 1960 was the owner of the fuel storage facility (1R.26).

(q) On January 1, 1960, the depreciable assets included in Plaintiff's fuel storage facility had an adjusted basis of $1,034,264.88. (1R.26)

(r) Plaintiff made a timely election to compute the depreciation deduction to be allowed to it on the declining balance method using a rate twice that allowed by the straight line method.

(s) Plaintiff's fuel storage facility would have no commercial use upon termination of use by the Government. Its only value would be as scrap value. (1R.27) (2R.100)
(t) Prior to the end of 1960, it had been announced that the last of the B-52 bombers was then "on the line" and that there was not going to be an extension of the B-52 contract. (2R.206)

2. Facts known after December 31, 1960.

The following facts became known or occurred after December 31, 1960.

(a) On January 13, 1961, Plaintiff sold its fuel storage facility for $1,934,250. (1R.26)

(b) On June 24, 1964 the Defense Fuel Supply Center requested Plaintiff to submit written proposals to it regarding possible amendments to the storage contract. If agreed to these amendments would have reduced the storage to be provided by the taxpayer from 270,000 to 215,000 barrels, change the use charge to be charged for the storage and change the length of the renewal period or periods from three periods of five years each to a single period of one year, a single period of three years, or a single period of five years, with options to renew on the

part of the Government for two one-year periods, fourteen one-year periods, four three year periods, or two five year periods. (Plaintiff's Exhibit 7)

(c) During the negotiations that followed Plaintiff offered to reduce the renewal price for the first five-year renewal period if the Government would relinquish its final two options to renew. (1R.27). The Government refused this offer: (1R.27).

(d) On September 1, 1964, the Government exercised its option to renew the fuel storage contract for the first of the three successive five-year renewal periods (1R.26) (Defendant's Exhibit 108)

(e) At the time the Government exercised its first five-year renewal option the Air Force requirements for fuel storage at the Grand Forks fuel storage facility totalled 208,000 barrels of capacity and were for a period of three years. (2R.137,170)

(f) The Government terminated its fuel storage contract at Helena, Montana prior to the completion of five years. (2R.146) Several other storage or pipeline facilities used by the Government have either been terminated or are presently being only sparingly used for the storage of Government owned petroleum products. (2R.206-210)

SPECIFICATION OF ERRORS RELIED UPON

1. The District Court erred in failing to conclude that upon the basis of facts known to the Taxpayer-Appellant

at December 31, 1960, Taxpayer-Appellant's estimate of a five year useful life for its fuel storage facility was reasonable.

2. The District Court erred in holding that it was permissible to use hindsight evidence in determining the useful life of Taxpayer-Appellant's fuel storage facility.

ARGUMENT

1. The District Court erred in failing to conclude that upon the basis of facts known to the Taxpayer-Appellant at December 31, 1960, Taxpayer-Appellant's estimate of a five year useful life for its fuel storage facility was reasonable.

A. Facts known to the Taxpayer at December 31, 1960

The facts which were known to the Taxpayer-Appellant at December 31, 1960 and upon which it based its estimate of the useful life of its Grand Forks, North Dakota fuel storage facility, are contained in the transcript of proceedings in this case, the Exhibits introduced into evidence and the District Court's Pre Trial Conference Order. Briefly, these facts include the Taxpayer's knowledge that its contract with the Government was for a five-year period; that while the Government also possessed successive options to renew the contract for three additional periods of five years each, there was no assurance or even likely prospect that it would do so; that the preliminary estimates of construction costs which the taxpayer had submitted to the Government had been premised upon a five year use-

ful life estimate; that the projected earnings and cash flow statements which it had submitted to its banker, the Old National Bank of Spokane, had likewise been premised on a five year estimate of useful life; that the terms of its loan from that bank, the National Bank of Minneapolis and the Red River Bank, required it to repay its construction loan over the five year period of its contract with the Government; and that its fuel storage facility would have no commercial or secondary use at the termination of the Government contract, however long that might be.

The military posture of the United States at the end of 1960, which is a matter of judicial knowledge, was one in which the United States was at war only in the cold war sense of seeking to maintain and extend its retaliatory military capacity against a possible air attack by the Soviet Union. While possession of the atomic bomb and the ability of the United States Air Force to deliver this bomb had been a focal point of our defense effort, a rapid change was taking place with the advent of the Minuteman Guided Missle system and the positioning of missle sites along the northern border of the United States. In addition, it was generally felt that the manned bomber would soon be obsolete as a retaliatory weapon and that its use would be continued only until such time as the country's missle system had become fully operative. These facts led the officers of the Taxpayer to assume that it would not be prudent or businesslike to depend on the Government to renew its storage contract beyond the initial five year period. (2R.93,197-199)

B. The Statute authorizing the awarding of five-year contracts.

Section 416 of Public Law 968, 70 Stat. at Large 991, 1018, 10 U.S.C. 2388, was enacted into law on August 3, 1956, and provides as follows:

> "*Section 416.* The secretaries of the military departments are authorized to contract for the storage, handling and distribution of liquid fuels for periods not exceeding five years, with options to renew for additional periods, not exceeding five years, for a total not to exceed 20 years. This authority is limited to facilities which conform to the criteria prescribed by the Secretary of Defense for protection, including disbursal and also are included in a program approved by the Secretary of Defense for the protection of petroleum facilities * * *"

The purpose of this provision was explained by the Senate Committee on Armed Services in its report (S.Rept. No. 2364, 84th Congress, 2d Sess., pages 28-29) as follows:

> The committee was informed that a year ago it was determined after study that a large percentage of our reserve stocks of petroleum, particularly aviation gasoline and jet fuel, are located in highly vulnerable areas of the United States. The Department, based on this determination, has attempted to achieve a program of dispersing that storage so that it will be outside the vulnerable areas and, therefore, will be available in the event of an emergency. The fuel stocks referred to are those intended for use in important missions immediately following the outbreak of hostilities. They are intended also for immediate shipment to overseas destinations. The study which the Department made of the situation in which it found itself indicated that there was little or nothing which could be done by the

> Department to rectify the situation. *For example, it found that the commercial petroleum storage industry was unwilling to undertake a program of dispersal outside of normal commercial areas.* The principal objection of the industries appeared to spring from the fact that under present laws the leasing of such dispersed facilities by the Department of Defense would be limited to 1 year. *The cost involved in such a dispersal program made it fully unattractive to the industries under this circumstance.* (italics supplied)

This explanation appears to have originated in the testimony of Col. C. A. Rogers who gave the following statement to the House of Representatives Committee on Armed Services (Hearings, Committee on Armed Services of the House of Representatives on Sundry Legislation Affecting the Naval and Military Establishments, 84th Cong. 2d Sess. Pages 6809-6810):

> *Colonel Rogers.* I am Col. C. A. Rogers from the Assistant Secretary of Defense's Office for Supply and Logistics.
>
> A year ago it was determined that a great percentage of petroleum, primarily aviation gasoline and jet fuel, are located in highly vulnerable areas, here in the United States. We have attempted to try to achieve a program of dispersing that storage so that it will be outside of these vulnerable areas and, therefore, will be available to us in the event of an emergency.
>
> These fuel stocks, of course, are intended for the important missions immediately following the outbreak of hostilities, and also for immediate shipment to overseas destinations.
>
> The work which we have accomplished in the last year leads us nowhere. We find that the commercial petroleum storage industry, of course, is unwilling to

undertake a program of this sort—that is providing the military with dispersed storage facilities—outside of normal commercial areas, because they will be limited under present law to a 1-year contract and, therefore, it would be exorbitant for us to try to enter into a mere 1-year contract to achieve our own objectives.

The individual 1-year cost will be exceedingly high, and we have introduced this measure in order to induce industry to go outside of their normal storage areas which are located in these highly vulnerable places, in order to build storage for us on a long-term basis and achieve the strategic protection which we feel is essential for these stocks.

* * *

The Chairman. And then the industry is providing the storage facilities of that petroleum that you buy today?

Colonel Rogers. That is correct; yes, sir.
The Chairman. That is limited to a 1-year contract?
Colonel Rogers. Yes, sir.

The Chairman. The only thing you are trying to do here is to have the permission to have a 5-year contract.

Colonel Rogers. That is correct; yes, sir.

The Chairman. You will then try to prevail on industry that with a 5-year contract they will be warranted in taking it out of a vulnerable area and putting it in an area not so vulnerable.

Colonel Rogers. That is exactly correct.

Mr. Fulling. Plus the fact that industry would engage in a program of protective construction as well as dispersing. (italics supplied)

The legislative history of Section 416 of Public Law 968 makes it abundantly clear that the commercial petroleum storage industry was unwilling to provide dispersed storage facilities outside of normal commercial areas because of the risks involved in a one-year contract with no guarantee of renewal. The solution to this problem was achieved by authorizing the military departments to enter into firm five year contracts. This feature resulted in the commercial petroleum storage industry being willing to provide the needed facilities as it then became possible to spread the investment cost over five years.

C. Negotiated contract ASP-17894.

Negotiated Contract ASP 17894 (Plaintiff's Exhibit 1) sets out the terms of the Taxpayer's contract with the Department of Defense. An analysis of this contract is vital to the Taxpayer's argument since it points up the business risks which the Taxpayer would have subjected itself to had it not utilized a five year useful life estimate for its fuel storage facility.

Section 1 of Negotiated Contract ASP 17894 sets forth the services to be furnished by the Taxpayer and the use charges to be paid by the Government during the initial five year term of the contract and during any renewal periods. The footnote to this section is important in that it indicates that the provisions dealing with payments during any of the option periods would not apply in the event the Government did not exercise one or more of its renewal options.

Section VII of the Negotiated Contract granted to the Government the option and successive options to renew its contract with the Taxpayer for three succeeding periods of five years each.

Section IX of the contract is important in that it established an option in the Government to purchase the fuel storage facility at the end of the fifth full year of the contract and at the end of each renewal period thereafter.

From the Taxpayer's standpoint, Section XII of the contract is especially significant in that it granted a right in the Government to terminate the contract for convenience. Paragraph C of Section XII, in particular, was significant from the standpoint of the taxpayer and its bankers for the reason that it set out the right of the Government to terminate its obligations under the contract, *without cost,* at the end of the fifth year of the contract, or at the end of any succeeding renewal period. The significance of this paragraph is that the Government, whether because of changed military needs or because of a change in the willingness of Congress to provide necessary funds, could have terminated its contract with the taxpayer at any time; and had it done so at the end of the first five year period, the taxpayer would have been left holding a fuel storage facility lacking any secondary or commercial use value. (1B.27) Under such circumstances, it was not surprising that the Taxpayer, as well as its bankers, insisted that the initial use charge be substantial enough to permit Taxpayer to recover its investment cost over the firm five year con-

tract period. To gamble that the contract would be renewed for one or more of the additional five year renewal periods certainly would not have been prudent or business-like. Moreover, there was nothing in the tax laws or in Section 416 of Public Law 968 that indicated that Congress expected a contractor such as the Taxpayer to speculate on the possibility that the Government would renew its contract for any additional period, let alone for another fifteen years. Compare Section 178(a) of the Internal Revenue Code of 1954, 26 U.S.C. (1960 Ed.) Sec. 178(a) (Appendix A, Infra).

D. The Statute and Regulations.

The income tax statute involved in this case is Section 167 of the Internal Revenue Code of 1954. 26 U.S.C. (1960 Ed.) Sec. 167 (Appendix A, Infra)

Paragraph (a) of Section 167 provides that "there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) on property used in a trade or business * * *"

Paragraph (b) of Section 167 provides that the term "reasonable allowance" shall include an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of several methods, including the declining balance method, using a rate not exceeding twice the straight line method.

Paragraph (c) of Section 167 limits the use of the declining balance method to property with a useful life of three years or more "the construction, reconstruction or erection which is completed after December 31, 1953" and paragraph (g) of Section 167 provides that the basis on which depreciation on obsolescence is to be allowed is the adjusted basis of the property provided in Section 1011.

The Income tax Regulations involved are Treasury Regulation 1.167(a)-1(a), 1.167(a)-1(b), 1.167(a)-9, 1.167 (a)-10(a) and 1.167(b)-0(a). (26 C.F.R. Sec. 1.167). The pertinent portions of these regulations are as follows:

> §1.167(a)-1. Depreciation in general.
>
> (a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section (167(f) and § 1.167(f)-1 for rules which permit reductions in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing

a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the act, economic changes, inventions and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-9. Obsolescence.

The depreciation allowance includes an allowance

for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete at some later date. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)-8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1.

§ 1.167(a)-10. When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for

such property or under the straight line method if no allowance has even been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

§ 1.167(b)-0. Methods of computing depreciation.

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

E. The relevant Treasury Regulations, as applied to the present case, require that the reasonableness of any claim for depreciation, including the estimate of useful life pertinent thereto, be determined upon the basis of facts known to exist at the end of the calendar year 1960.

Treasury Regulation 1.167(b)-0(a) specifically states that "the reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to

exist at the end of the period for which the return is made." The Courts have upheld the validity of this interpretation of the Statute and have similarly considered a "reasonable allowance" under Section 167 to mean one based on the expected useful life of the depreciable assets in the light of facts known or reasonably ascertainable at the end of the current taxable year. *Leonard Refineries, Inc.*, 11 T.C. 1000 at 1006 (1948); *Lake Charles Naval Stores*, 25 B.T.A. 173, at 178-179 (1932); *Commissioner v. Mutual Fertilizer Co.*, 159 F.2d 470 (C.A.5, 1947) and *Commissioner v. Cleveland Adolph Mayor Realty Corporation*, 160 F.2d 1012 (C.A.6, 1947).

In this regard, it should be noted that this particular regulation has appeared in essentially its present form since 1922. (See Reg. 62, Article 165, 1922 edition). This fact is significant for the Supreme Court has held that "Treasury Regulations and interpretations long continued without substantial change applying to unamended or substantially re-enacted statutes, are deemed to have received congressional approval and have the effect of law." *Halvering v. Winmill*, 305 U.S. 79, 59 S.Ct. 45 (1938). Moreover, the Court of Appeals for the Ninth Circuit has held that Treasury Regulations are binding on the Commissioner and Taxpayer alike. *Pacific National Bank v. Commissioner*, 91 F.2d 103. (C.A. 9, 1937).

F. Cases involving Military facilities

There have been a number of cases in which the Courts have been called upon to determine the useful life of mili-

tary related facilities. For example, it is interesting to note that the well known tax case, *Cohn v. United States*, 259 F.2d 371 (C.A. 6, 1958) involved facts quite similar to those in the instant case.

In the *Cohn* case, the taxpayer had established flying schools during World War II under separate contracts with the Government. The terms of these contracts were for one year or from the beginning of the school until the following June 30, whichever was the shorter, and were cancellable without cause on 30 days notice. While no assurance of renewals or extensions was made, the taxpayer expected the contracts to last from 2 to 4 years and established the useful life of its depreciable assets on that basis but made no allowance for salvage value.

During the latter part of 1944, the various contracts were terminated and the depreciable assets sold. The sales price in each instance was an amount in excess of the adjusted basis of the depreciable assets as at the beginning of the year of the sale. The Commissioner of Internal Revenue contended that the various items of property had useful lives of from five to ten years. The District Court held, however, and the Court of Appeals affirmed, that the taxpayer's estimate of useful life had been reasonable.

The Tax Court Memorandum Decision, *John Paul Riddell*, 12 T.C.M. 44, (1953) involves an even more comparable situation. In that case the taxpayer partnership, in 1941, organized a pilot training school and entered into

contracts with the British government to train students of the Royal Air Force. Pursuant to such contracts, substantial improvements were made to an air field located in a remote area. Following completion of the air field and after some 14 months of operation, the property was sold to the United States Government although the partnership continued to operate the air field under a lease for another 30 months. According to the Tax Court's Finding of Fact the useful life of the permanent installations at the air field would ordinarily be more than two years. However, the taxpayer partnership reasonably thought that flight training would not last more than two years and on that basis directed its auditor to depreciate the cost of the air field over the 24 month period. The term was chosen in preference to the five year emergency amortization term which the taxpayer partnership might have elected under Section 124 of the Internal Revenue Code of 1939. 26 U.S.C. (1944 ed.) Sec. 124, the predecessor to Section 168 of the Internal Revenue Code of 1954, 26 U.S.C. (1960 ed.) Sec. 168. (See Appendix A, Infra). The Commissioner, on the other hand, determined that a 60 month term should be utilized.

The Tax Court treated the issue as one of fact. It found that the useful economic life of the training field was tied in with a period of hostilities, and that the field would have no use at the end of that period. Based on this Finding, it held that there was sufficient evidence to support a determination that the two year estimate for depreciation had been proper.

A third case, *Fribourg Navigation Co., Inc. v. Commissioner,* 383 U.S. 272, 86 Sup. Ct. 682 (1966) although it involves a somewhat different issue, is significant for the light it throws upon the concept of depreciation and for the manner in which it rejects the use of hindsight evidence to disrupt reasonably arrived at estimates of useful life and salvage value.

In *Fribourg,* the taxpayer purchased a large ship in December, 1955, for $469,000 after having acquired an Internal Revenue Service private letter ruling which stated that the Service would accept [redacted] (1) straight line depreciation of the ship over a useful life of three years, and (2) a $54,000 salvage value.

The adjusted tax basis of the ship at the beginning of 1957 was $327,626. As a result of the Suez crisis of 1956-1957 the market value of ships rose sharply. In June of 1957 the taxpayer accepted an offer to sell the ship for an amount well in excess of its January 1, 1957 adjusted basis. The sale of $695,500 was consummated on December 21, 1957. The taxpayer claimed a deduction for depreciation up to the date of sale.

The Commissioner's disallowance of the entire year of sale depreciation deduction was sustained by the Tax Court and by the Court of Appeals for the Second Circuit. The latter court, in affirming, considered that the sale established with mathematical certainty that the entire cost of the asset had been recovered. Therefore, no injustice could

result from denying the taxpayer an allowance for depreciation in the year of sale.

The Supreme Court reversed the decision of the Court of Appeals and allowed the depreciation deduction claimed in the year of sale. It held that the Commissioner's position commingled two distinct and well established concepts of tax accounting — depreciation of an asset through wear and tear or the gradual expiration of useful life, and fluctuations in the value of that asset through changes in price levels or market values.

One of the contentions of the Commissioner in the *Fribourg* case was that Treasury Regulation 1.167(b)-0(a) required that depreciation be determined on the basis of conditions known to exist at the end of the period for which the return was made. Thus, since the taxpayer knew that the sale of the ship had "cost" it "nothing" in the year of sale, the argument ran, the depreciation deduction for such year should be disallowed. The Court rejected this reasoning stating that this argument ignored the distinction between depreciation and gain through market appreciation. It also pointed to the interplay of Section 167 and the capital gain provisions, which interplay was reflected in the Section 167 Regulations. Finally, the Supreme Court pointed to the long-continued administrative practice which had allowed depreciation in the year of sale.

Fort Lewis Dairy v. Squire (W.D. Wash., 1954) (unreported) 1954-1 U.S.T.C. 9396 (1954)) is still another

case involving military facilities. There, the District Court held that the cost of improvements made to the taxpayer's dairy on the Fort Lewis Military Reservation should be depreciated over the five year term of the taxpayer's lease rather than over a longer period, even though a new lease was granted retroactively for an additional period of five years.

And still earlier, in *United States Cartridge Co. v. United States,* 284 U.S. 511, 52 S.Ct. 243 (1932) the Supreme Court held that in the case of a World War I ammunition maker the cost of buildings erected in 1917 could be recovered (except for salvage value) over the period ending with the cessation of hostilities. See also *United States v. Wagner Electric Mfg. Co.,* 61 F.2d 204 (C.A. 8, 1932).

Lastly, mention should be made of the admonition in Section 1016 of the Internal Revenue Code, 26 U.S.C. 1960 ed.) Sec. 1016, (Appendix A. Infra), that for purposes of determining gain or loss on the sale of property, the basis of such property must be adjusted for the greater of the depreciation allowed *or* allowable in prior years. The significance of this is that had the Taxpayer in this case overestimated the useful life of its fuel storage facility it could have been faced with the contention that its basis for the property should have been reduced by the aggregate of the depreciation deductions which would have been allowed to it had it originally made a correct estimate of useful life. Under such circumstances the taxpayer did the only thing it could do to protect its financial posi-

tion and to satisfy the representations which it had made to the Government and to its bankers regarding the existence of an adequate after-tax cash flow from the government contract. This was to assume that the Government would not exercise any of its renewal options, let alone all three of these renewal options.

G. Summary

The conclusion one reaches in reading the legislative history of Section 416 of Public Law 968, *supra,* is that, prior to 1956, the Air Force had not been able to "induce" the commercial petroleum storage industry to provide fuel storage facilities in remote or dispersed areas because of the risks involved in making such a large investment in plant and equipment with only an assurance of a one-year contract, and with single year renewals at the option of the Government. Similarly, the obvious conclusion one reaches in reading Negotiated Contract ASP 17894, and in reading the testimony of the witnesses appearing at the trial of the instant case, is that the Taxpayer was "induced" into constructing its fuel storage facility at Grand Forks, North Dakota, on the basis that it would be permitted to recover its investment in the property during the firm five-year contract. In other words, the purpose of Section 416 of Public Law 968 was to remove or reduce the risk of loss to the commercial petroleum industry in building a single purpose fuel storage facility in a non-commercial area. And just as there was the danger under the prior law that the Government would not renew its contract a sufficient

number of years to permit a facility owner to recover back its initial investment, so here there was the danger that the Government would not renew its five-year contract a sufficient number of times to permit the taxpayer to recover back its initial investment. Consequently, taxpayer, like other petroleum storage contractors, had to be able to justify entering into the contract on the basis of being guaranteed a return of its capital investment during the initial five year period since, unlike the ownership of fuel storage facilities in commercial storage areas, there would be no secondary use for the facility in the event of the failure on the part of the Government to exercise one or more of its renewal options.

Assuming then that the District Court had limited its examination of the facts to those which were either known or reasonably ascertainable at December 31, 1960, it would have recognized that the United States was not then at war (Compare 2R-263), and it would not have taken into consideration the fact that the Government had, begrudgingly exercised its option to renew its contract with the Taxpayer for the first of its three successive five year renewal periods. Assuming, likewise, that the District Court had limited its examination of the facts to those which were either known or ascertainable at December 31, 1960, it would not have accepted the word of Col. Morfield that the Grand Forks Air Force Base would be utilized for the full 20 years (2R.263) as Col. Morfield was not even assigned to the Air Force Fuel Petroleum Supply Office

until August of 1964 (2R.230) which was some three and one-half years after the date the estimate of useful life was required to be made.

Instead of the abovementioned facts, the District Court should have asked itself whether, based upon the legislative history of Section 416 of Public Law 968, the indecisiveness of the Air Force as to its fuel storage requirements at Grand Forks, North Dakota, the termination for convenience provisions of Negotiated Contract ASP 17894 and the stipulated fact that there would be no commercial use for the fuel storage facility at the end of the Government contract, it was "more probable" than not that the Government would renew its contract with the Taxpayer, and, if so, whether it was more probable than not that the contract would be renewed for an additional period of five years, an additional period of ten years, or an additional period of fifteen years. Compare *Pasadena City Lines, Inc.*, 23 T.C. 34, at 38 (1954) and *Bonwit Teller and Co. v. Commissioner*, 53 F.2d 531 (C.A. 2, 1931) with Section 178 of the Internal Revenue Code of 1954, (Appendix A, Infra). The District Court Failed to ask itself this question and its failure to do so constituted reversable error.

2. The District Court erred in holding that it was permissible to use hindsight evidence in determining the useful life of taxpayer's fuel storage facility.

A. The District Court's Reasoning.

The facts adduced at the hearing in this case establish that the Taxpayer did not know at the end of either 1959

or 1960, nor could it have known at those times, that the Government would renew the fuel storage contract for an additional five year period. These facts also establish that it is still too early to know whether or not the Government will renew its contract for one or both of the two remaining five-year renewal periods. Notwithstanding these facts, the District Court held that on the basis of hindsight evidence, i.e. the one renewal of the contract, the continued existence of the cold war, and the testimony of Col. Morfield that he was of the opinion that the Air Force would continue to use the Grand Forks Air Base during the remaining two five year option periods, a useful life estimate of twenty years should have been utilized by the Taxpayer in determining allowable depreciation for the year 1960.

Counsel for the Plaintiff objected to the admission of hindsight evidence at the trial (2R.35) but its objection was overruled (2R.248).

That the use of hindsight evidence was the factor that weighed heaviest in the mind of the District Court is evidenced by the following statement by the Court:

> "Then, of course, there the Plaintiff's estimate of the length of actual contract was five years and in calculating their needs, financial needs, they used that figure as their method of depreciating this facility so that they would have sufficient cash flow to pay all of their obligations, including taxes, to pay off the financing arrangements.
>
> However that estimate they made would have to be the basis for my decision in favor of the taxpayer and

that alone; just the fact that they estimated it at that, because there isn't any other facet here that I have heard, upon which to decide in favor of the taxpayer. *It is just that they thought it would only go 5 years and they had some good reasons for feeling that way, I am sure, however it didn't run out that way, so that estimate on their part appears to be in error.* So that when you talk about sustaining the burden of proof in this case, that means to the court the more convincing power of the evidence and I can't be convinced that that estimate as contrasted to the bid itself, and the hindsight, the fact that it just didn't turn out that way, and the facility is still in use, and it appears from the testimony of Col. Morfield that it is going to be in use, I think, at least balances the scale, in fact tips them in favor of the defendant, the government here so that on the basis of the testimony I would find as a matter of fact that the Plaintiff has failed to sustain the burden and I would have to decide therefore in favor of the government that the plaintiff was not entitled to depreciate this facility on this formula that they used which was a five year useful life basis." (2R.259-261)

* * *

Well, I said 20 years, strictly on the basis of what Col. Morsfield said, plus the fact that I have to take judicial knowledge of that fact that we are at war." (2R.263)

* * *

One other thing, if I do decide this as I have indicated, and I don't change my mind in accordance with your argument, in the decision I am going to put it as they should say on the street "cold turkey" that I did use hindsight; so that when the Circuit sees it, which they undoubtedly will because of the magnitude of this case, which involves a lot of money, they will

know exactly what my thinking was. I will put it right in the decision." (italics supplied) (2R.248)

That Col. Morfield's testimony was based on hindsight evidence is illustrated by the fact that he first became associated with the Air Force Petroleum Supply Office in August of 1964. (2R.230) That date was more than three years after the close of the taxable year in question. Instead of being harmful, Col. Morfield's testimony is helpful to the Taxpayer's argument since he admits that the Air Force method of projecting future fuel storage requirements did not extend beyond five years (2R.232). This fact is implicit in the underlying contract itself which permits termination without cost to the Government at the end of the first five year period and at the end of each five year period thereafter. It is also implicit in the testimony of Frances J. DeFavio to the effect that the Government's own estimate of its storage requirements did not exceed five years, and in the instant case were reduced to three years and to 208,000 barrels of capacity at the time of the first renewal of taxpayer's fuel storage contract. (2R.139,169)

Based on these facts and on the further fact that none of the questions which were asked of the witnesses Col. Morefield and Frances J. DeFavio, Jr. were premises on conditions known to exist at December 31, 1960, it is obvious that their testimony was based wholly on hindsight evidence and on their present estimate of what the future defense needs of the United States might be. Certainly, something more than this type of evidence is required as proof of facts existing at the end of the year 1960.

B. The Mutual Fertilizer Company Case

As indicated earlier in this brief, Treas. Reg. 1.167(b)-0(a) requires that "the reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made." The impact of this regulation, insofar as it had application here, is best illustrated by the decision of the Court of Appeals of the Fifth Circuit in the case *Commissioner of Internal Revenue v. Mutual Fertilizer Company,* supra. In that case the taxpayer, in its tax returns for the years 1921 through 1923 and 1927 through 1933, did not claim and was not allowed depreciation on its plant. For the years 1924 through 1926, it claimed and was allowed depreciation on the basis of an estimated useful life of its plant of from 5 to 7 years, from June 1, 1920. For 1934 and 1935 the Commissioner determined a 20 year useful life for the plant dating from June 1, 1920. The taxpayer acquiesced in this adjustment. For the years 1939 to 1941, however, the Commissioner determined that the useful life of the plant would extend to June 1, 1953, and the taxpayer conceded that this was correct. In determining the adjusted basis for depreciation in the taxable years 1939 to 1941 a controversy arose over the method of determining the amounts "allowable" for those ten years in which no depreciation had been claimed and none was in fact "allowed". In disposing of this issue, the Tax Court stated:

> "The case is one in which a 20 year useful life was mistakenly applied in 1934 and it now appears that

> the proper life span was at all times 33 years. Under the circumstances we think it must be held that depreciation allowed for the years in question should be computed upon the longer useful life." *Mutual Fertilizer Company v. Commissioner*, 5 T.C. 1122, at 1125 (1945).

The Court of Appeals, in reversing, made specific reference to the earlier quoted income tax regulation and stated:

> "The error of the Tax Court lies in its majority's view that it "now appears" years after the end of the periods for which "allowable" amounts must be determined, that 33 years is and was the forseeable useful life of the plant assets. *The critical factor is not what "now appears" but what "then appeared" to be the useful life of the plant. That is, what reasonably was known and ascertainable at the end of each of such periods as to the reasonably forseeable useful life of the plant."* (italics supplied) *Mutual Fertilizer Company v. Commissioner, supra, at 472.*

Accordingly, since the Commissioner had determined that at the end of the prior periods the reasonably forseeable useful life of the plant had been 20 years from June 1, 1920, it was held that the Commissioner's determination must stand in the absence of proof that it was wrong.

C. Other cases rejecting the use of Hindsight Evidence

There have been a number of other cases where courts have held that it was not proper to consider hindsight evidence in determining the rate of depreciation or the useful life of depreciable assets. For example, in *Commissioner*

v. Cleveland Adolph Mayor Corporation, supra, the Court of Appeals for the Sixth Circuit reversed still another decision of the Tax Court which had held that "allowable" depreciation in respect of a building should be based upon facts learned years after the original estimate of useful life had been made. In applying the language of Treas. Reg. 1.167(b)-0(a) to the facts of that case, the Court of Appeals concluded that the Tax Court had committed error in utilizing hindsight evidence to determine the amount of depreciation which was allowable in three earlier years. What is interesting is that the Court of Appeals, in support of its decision, referred to the 1932 amendment to Section 113(b) (1) (b) of the Revenue Act of 1932 and to the report of the Senate Finance Committee, S. Rept. 665. 72nd Congress, 1st sess., 29, which read as follows:

> "Your Committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the treasury as the regulations of the treasury seem adequate to protect the interest of the taxpayers in such cases. *These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts, and to not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years by which such allowances are made.*" (italics supplied)

The decision of the Circuit Court was that facts subsequently developed should be reflected in the allowances for subsequent years, but that they should have no retroactive force or effect. *Alpin J. Cameron, et al.* 8 B.T.A. 120 (1927); *Fireman's Insurance Co.,* 30 B.T.A. 1004, 1011

(1934); *Wilkins, Important Developments in Deductability of Repairs; Depreciation; Depletion allowances,* 6 New York University Institute of Taxation, 637, 642-654 (1948).

D. Summary

The Income Tax Regulations require a taxpayer in estimating the useful life of a depreciable asset to apply his experience with similar property and to take into consideration the then existing conditions and "probable" future developments. The officers of the Taxpayer followed this procedure in determining, at the end of 1959, and once again at the end of 1960, that it was not "probable" that the Government would exercise its option to renew its fuel storage contract for one or more of the three five-year renewal periods. And the District Court admitted "they had some good reasons for feeling that way" (2R.260). Under those circumstances the estimate which was made by the Taxpayer-Appellant should not be upset, even if subsequent events prove it to be partially erroneous. *Kennecott Copper Corp. v. United States,* 347 F.2d 275 at 285 (Ct. Claims. 1965).

CONCLUSION

The Judgment of the District Court should be reversed and the case remanded for entry of Judgment for the Plaintiff. In the alternative, the Judgment of the District Court should be reversed and the case remanded for the purpose of determining whether, based on the facts known to the Plaintiff at the close of 1960, it was more probable than not that the Government would renew Negotiated Contract ASP 17894 with the Taxpayer and, if so, whether it was more probable than not that it would be renewed for an additional five years, for an additional ten years, or for an additional fifteen years.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

DATED this 4th day of March, 1968.

Scott B. Lukins

Scott B. Lukins

APPENDIX "A"

Internal Revenue Code of 1954

SEC. 167. DEPRECIATION.

[Sec. 167(a)]

(a) *General Rule.* There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

Source: Sec. 23(l) (1), 1939 Code.

[Sec. 167(b)]

(b) *Use of Certain Methods and Rates.* For taxable years ending after December 31, 1953, the term "reasonable allowance" as used in subsection (a) shall include (but shall not be limited to) an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

(1) the straight line method,

(2) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in paragraph (1).

(3) the sum of the years-digits method, and

(4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of

the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in paragraph (2).

Nothing in this subsection shall be construed to limit or reduce an allowance otherwise allowable under subsection (a).

Source: New.

[Sec. 167(c)]

(c) *Limitations on Use of Certain Methods and Rates.* Paragraphs (2), (3), and (4) of subsection (b) shall apply only in the case of property (other than intangible property) described in subsection (a) with a useful life of 3 years or more—

(1) the construction, reconstruction, or erection of which is completed after December 31, 1953, and then only to that portion of the basis which is properly attributable to such construction, reconstruction, or erection after December 31, 1953, or

(2) acquired after December 31, 1953, if the original use of such property commences with the taxpayer and commences after such date.

Source: New.

* * *

[Sec. 167(g)]

(g) *Basis for Depreciation.* The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011 for the purpose of determining

the gain on the sale or other disposition of such property. Source: Secs. 23(n), 114(a), 1939 Code.

(26 U.S.C., 1960 ed., Sec. 167)

SEC. 168. AMORTIZATION OF EMERGENCY FACILITIES.

[Sec. 168(a)]

(a) *General Rule.* Every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any emergency facility (as defined in subsection (d)), based on a period of 60 months. Such amortization deduction shall be an amount, with respect to each month of such period within the taxable year, equal to the adjusted basis of the facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in the period. Such adjusted basis at the end of the month shall be computed without regard to the amortization deduction for such month. The amortization deduction above provided with respect to any month shall, except to the extent provided in subsection (f), be in lieu of the depreciation deduction with respect to such facility for such month provided by section 167. The 60-month period shall begin as to any emergency facility, at the election of the taxpayer, with the month following the month in which the facility was completed or acquired, or with the succeeding taxable year.

(26 U.S.C., 1960 ed., Sec. 168)

SEC. 178. DEPRECIATION OR AMORTIZATION OF IMPROVEMENTS MADE BY LESSEE ON LESSOR'S PROPERTY.

[Sec. 178(a)]

(a) *General Rule.* Except as provided in subsection (b), in determining the amount allowable to a lessee as a

deduction for any taxable year for exhaustion, wear and tear, obsolescence, or amortization—

(1) in respect of any building erected (or other improvement made) on the leased property, if the portion of the term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) remaining upon the completion of such building or other improvement is less than 60 percent of the useful life of such building or other improvement, or

(2) in respect of any cost of acquiring the lease, if less than 75 percent of such cost is attributable to the portion of the term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) remaining on the date of its acquisition,

the term of the lease shall be treated as including any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, unless the lessee establishes that (as of the close of the taxable year) it is more probable that the lease will not be renewed, extended, or continued for such period than that the lease will be so renewed, extended, or continued.

(26 U.S.C. 1960 ed., Sec. 178)

SEC. 1016. ADJUSTMENTS TO BASIS.

[Sec. 1016(a)]

(a) *General Rule.* Proper adjustment in respect of the property shall in all cases be made—

* * *

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under section 167 (b) (1). * * *

(26 U.S.C. 1960 ed., Sec. 1016 (a)

Treasury Regulations on Income Tax (1954 Code)

§ 1.167(a)-1. Depreciation in general.

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)-1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)-1 for rules which permit reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts represent-

ing a mere reduction in market value. See section 179 and § 1.179-1 for a further description of the term "reasonable allowance."

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)-1.

(26 C.F.B., Sec. 1.167 (a)-1)

§ 1.167(a)-9. Obsolescence.

The depreciation allowance includes an allowance for

normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete at some later date. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see § 1.167(a)-8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and § 1.167(d)-1. [Reg. 1.167(a)-9.]

(26 C.F.B. Sec. 1.167(a)-9)

§ 1.167(a)-10. When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line

method if no allowance has even been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an "averaging convention", that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167(b)-1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance

for the taxable year, it may not be used. [Reg. § 1.167(a)-10.]

(26 C.F.B., Sec. 1.167(a) Sec. 1.167(a)-10)

§ 1.167(b)-0. Methods of computing depreciation.

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost of other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)-1, 1.167(b)-2, 1.167(b)-3, and 1.167(b)-4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)-1. See also § 1.167(e)-1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.* In the case of item accounts, any method which results in a reasonable allow-

ance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167

(e)-1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and § 1.167(c)-1 for restriction on the use of certain methods. See also § 1.167(a)-7 for definition of account. [Reg. § 1.167(b)-0.]

(26 C.F.B Sec. 1.167(b)-0)

APPENDIX "B"

TABLE OF EXHIBITS PURSUANT TO RULE 18(2)F AS AMENDED:

Plaintiff's Exhibits 1 through 10 and 12 and Defendant's Exhibits 101-110 were identified and admitted in evidence as set forth in the Transcript of Proceedings.